



# MONTANA LEGISLATIVE BRANCH

## Legislative Fiscal Division

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Legislative Fiscal Analyst  
CLAYTON SCHENCK

DATE: March 17, 2006

TO: Legislative Finance Committee

FROM: Greg DeWitt *Greg DeWitt*

RE: March Supplemental – Department of Revenue

### DESCRIPTION OF PROPOSAL

A supplemental appropriation proposal has been submitted to address a general fund shortfall in the Department of Revenue associated with funding expert witness and other litigation expenses for defending six tax appeal cases. According to the proposal, the six appealed cases involve litigation costs associated with \$54.6 million in state and local taxes. The current proposal is to make up to \$375,000 of FY 2006 general fund expenditures with appropriations for FY 2007. The proposal letter from the Office of Budget and Program Planning and the justification letter from the Department of Revenue are enclosed for reference.

### DOES THE PROPOSAL SATISFY STATUTE?

#### UNFORESEEN AND UNANTICIPATED EMERGENCY

The statute governing supplemental appropriations, authorizing the approving authority to authorize expenditures for FY 2006 to be made with appropriations for FY 2007, require that the expenditures are for an unforeseen and unanticipated emergency. Staff has reviewed the proposal and raises no issues over the assertion that the expenditures are for an unforeseen and unanticipated emergency, for the following reasons.

- o The department could not have anticipated that the taxes would be contested
- o Failure to defend the state's tax claim in these cases would likely result in a forfeiture of \$54.6 million in local and state tax revenues, and would have serious consequences to state and local finances and operations

#### PLAN FOR REDUCING EXPENDITURES

Another condition for the approving authority to authorize a supplemental appropriation is development of a plan to reduce expenditures in FY 2007 that allows the agency to contain expenditures within appropriations. Upon reviewing the supplemental appropriation proposal as submitted, staff raises the following issues.

### Issue – Plan Does Not Contain Expenditures Within Appropriations

Were the state to litigate the appealed tax cases to the extent identified in the proposal, the expenditures, specific to this proposal, would not be limited to FY 2006, but would recur in FY 2007. The department estimates that the additional FY 2007 shortfall for associated expenses would be \$653,444 for a total biennium shortfall of \$1,025,492. As such, the committee should be aware that it is likely that a request would be presented to the 2007 Legislature in the supplemental bill to fund litigation costs.

### Issue – Plan Does Not Specify One Reduction Plan

As submitted, the supplemental appropriation proposal does not specify what specific expenditures would be reduced to maintain expenditures for the biennium within legislative appropriations. The issue primarily rests with the fact that two mutually exclusive reduction plans were provided in the proposal and the question is, which plan will be implemented? The proposal lists the following two reduction plans:

- o An across-the-board general fund reduction affecting all divisions of the department
- o A reduction of audit and compliance activities

Staff has met with the department to provide further details of services that would be reduced under each plan, but has not been successful in determining which plan would be implemented. So, technically, the proposal does not currently pass statutory muster for the Governor to approve a supplemental appropriation.

### Issue - Adversely Impacts State and Local Revenues

As submitted and clarified through discussions with the department, both plans would only address the technical requirements of the law, to reduce expenditures within appropriations. However, both plans would result in state and local revenue reductions that far exceed the savings to keep expenditures within appropriations. The department anticipates that by reducing expenditures by \$1.0 million to offset the litigation costs associated with the appealed tax cases for the entire 2007 biennium would result in revenue reductions of \$11.8 million and \$7.2 million depending upon which plan is implemented. As such, the practicality of both plans is questionable. Staff has identified and suggested to the department alternative reductions that would not directly impact revenues, but were not included in either reduction plan.

## **THE NEXT STEP**

Staff is in the process of analyzing the proposal further with involvement by the members of General Government and Transportation Joint Appropriations Subcommittee of the 2005 Legislature, as directed by the committee at its March 2006 meeting. Additional questions have been posed to the department, as will be any questions from appropriations subcommittee members so that a final determination and recommendations can be reported to the committee prior to the June committee meeting.

OFFICE OF THE GOVERNOR  
BUDGET AND PROGRAM PLANNING  
STATE OF MONTANA



BRIAN SCHWEITZER  
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TO: Clayton Schenck, Legislative Fiscal Analyst  
Legislative Fiscal Division

FROM: David Ewer, Budget Director  
Office of Budget and Program Planning

DATE: March 6, 2006

SUBJECT: **LFC Review and Comment on a Fiscal Year Transfer Supplemental  
Appropriation**

In accordance with Title 17, Chapter 7, part 3, MCA, the Governor's Office of Budget and Program Planning is submitting for review and comment at the March meeting of the Legislative Finance Committee one proposed supplemental appropriation to transfer FY 2007 authority to FY 2006.

- The **Department of Revenue** has requested a transfer of up to \$375,000 from FY 2007 to FY 2006. The Department of Revenue is estimating a general fund appropriation shortfall of \$1,025,492 during the 2007 biennium attributable to defending appeals in five centrally assessed property tax cases and one corporate income tax case involving \$54,647,466 in state and local tax revenue. The \$1,025,492 biennial budget shortfall for legal defense costs is estimated at \$372,048 for FY 06, and \$653,444 in FY 07. These costs will be incurred for expert witness and outside counsel, travel for depositions, and other litigation expenses for these eight cases. Failure to defend these cases could result in the loss of nearly \$55,000,000 in state and local revenue. Attached to this letter is a detailed memo describing the necessity of the budgetary transfer as well as the statutorily required expenditure reduction plan for FY 2007.

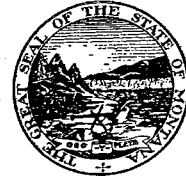
Please let us know if you wish additional information on this transaction.

C: Dan Bucks  
Lisa Smith  
Taryn Purdy



Dan Bucks  
Director

# Montana Department of Revenue



Brian Schweitzer  
Governor

March 6, 2006

TO: David Ewer, Director  
Office of Budget and Program Planning

FROM: Dan Bucks, Director  
Department of Revenue

SUBJECT: General Fund Shortfall

The Department of Revenue is estimating a general fund appropriation shortfall of \$1,025,492 during the 2007 biennium attributable to defending six appeals involving \$55 million in state and local tax revenue. Five are centrally assessed property tax cases and one is a corporate income tax case. The \$1,025,492 biennial budget shortfall for legal defense costs is estimated at \$372,048 for FY 06, and \$653,444 in FY 07. These costs will be incurred for expert witness and outside counsel, travel for depositions and other litigation expense for these six cases.

In specific terms, the department is requesting, pursuant to MCA Title 17, Chapter 7, Part 3, to expend in FY 06, \$372,048 of general fund authority from FY 07. Further, the department will seek a supplemental appropriation from the 2007 legislature to cover the estimated \$1,025,492 in legal defense costs.

These expenditures are necessary to properly defend the state's position in these complex cases. Failure to successfully defend these cases would jeopardize \$55 million in state and local revenue. If local governments were to increase mill levies to make up their share of this loss, \$43.5 million in property tax revenues would be shifted to other property tax classes, including \$28.3 million to residential and commercial property. The average homeowner would experience a \$61 increase in property taxes.

In the longer term, if the state fails to defend the property values and assessments for major corporations, the state will create an incentive for corporations to file more protests for even larger amounts of taxes in the future. So the state is in the position of paying to defend these cases now, or paying even more to defend a larger number of cases in the future.

It had been standard appropriations practice in past years to provide the department with a contingency fund for legal defense. That practice ceased in 2003. Ceasing that practice may well have sent a signal to the corporate taxpayer community that the state was not prepared to fully defend its property and corporate tax assessments.

The estimated funds for defending the state's position in these larger, complex cases are the minimum necessary to achieve a successful result. The companies will expend even greater sums for multiple experts and attorneys. The state cannot afford to, in effect, default in these cases by devoting fewer resources than are necessary to support its valuations.

The department believes that its values and assessments are sound. We will vigorously defend these values and assessments to protect the integrity and equity of the state and local tax base, minimize future appeals and ensure fairness for all Montana taxpayers.

#### Incentives for Corporations to File Appeals with Questionable Merit

Corporations have incentives to file appeals even if there is questionable merit to their positions. The amount of the taxes at issue and the substantial financial resources that corporations can devote to tax matters leads to the widespread filing of appeals regardless of the merits. The random chance of getting a sympathetic hearing by a tribunal is sufficient incentive for some companies to file appeals. Some corporations make the filing of property tax appeals in most or all states a regular business practice. At least two of these six cases involve companies that are appealing their state assessed property taxes in most states. So it makes no difference what the state's assessment practice is, companies with this "protest everywhere" business practice will file tax appeals. Two additional cases involve corporations that have hired a national accounting firm that file appeals on a contingency basis, receiving a portion of any tax reduction that results from the appeal. So the corporation does not need to put up any significant resources to undertake an appeal, but has at least some random chance of getting some reduction in taxes—and a very high chance of winning an appeal if the state does not defend its position effectively.

Large corporations may place in protest funds amounts of money well beyond what they can reasonably expect to gain from an appeal. Doing so causes unnecessary budget uncertainty and strain for local governments and school districts. The state needs to effectively defend the values it establishes to protect the local property tax base.

The appeal practices of a few large companies contrasts with the approach of the majority of the 120 centrally assessed enterprises—many of which are rural electric cooperatives and smaller companies. The property valuation methodology applied to cooperatives and small companies is the same as is applied to the largest companies. Yet, the cooperatives and small companies do not find the same necessity to appeal.

Large corporations operate in a different realm from ordinary taxpayers. Ordinary citizens do not have the amount of taxes at stake or the resources to bring tax appeals that have doubtful merit. No national accounting firm is going to knock on the doors of homeowners or main street businesses offering to appeal their property taxes, because the amount at stake is too little to attract the interest of the national firm. Thus, homeowners and main street businesses will typically not file questionable appeals. Corporations have greater ability to file appeals and seek tax advantages from the

appeals process. Failure of the state to properly defend against these corporate appeals will only disadvantage the ordinary homeowner and main street business.

#### Legacy of Deregulation a Contributing Factor

Two of the six cases for which this funding request is made involve successor companies to the Montana Power Company. (There are two additional property appeals that fall in this same post-deregulation category, but for which no funding is being requested.) Deregulation of the electric and natural gas industries has led to a reorganization of companies and assets that inevitably produce questions of the application of existing centrally assessed property laws in this new context. The same process of increased property tax appeals occurred after the federal government reduced its regulation of the railroad and airline industries. Whatever the costs have been to Montana citizens from deregulation, there should not be an additional cost in the form of tens of millions of dollars in tax shifting to homeowners, main street businesses, and farmers and ranchers because the state fails to defend its position in these cases.

#### Examples of Why the State Needs to Defend Its Tax Valuations

The Department of Revenue believes strongly that it needs to vigorously defend its tax valuations. The state would be remiss if it did not defend against these appeals.

PacifiCorp is appealing a portion of its property taxes which are based on a value of their entire business that the state has determined to be \$7.2 billion. In the same year, PacifiCorp accepted, subject to regulatory approval, a purchase offer of \$9.4 billion from a Warren Buffet enterprise. Thus, it appears that the department's valuation may be conservative.

Northwestern Energy is appealing a portion of its property taxes which are based on the value of their entire business that the state has determined to be \$1.7 billion. While they contend this value is too high, in the same year they rejected a purchase offer by five Montana cities of \$2 billion. The department's valuation appears conservative in light of the rejected purchase offer. Northwestern's appeal was filed on its behalf by a national accounting firm that receives its compensation as a portion of any tax reduction realized from the appeal.

PPL Montana has protested \$35 million in property taxes for tax years 2000 through 2005. One of their major arguments is that, even though they sell electricity in deregulated markets, they should be treated just like the regulated electric utilities. The department strongly disagrees because their market location and opportunities are very different. Ironically, if the department had applied its appraisal formulas to PPL in a manner identical to its average treatment of regulated utilities, PPL's property taxes would have gone up. PPL has appealed their property tax as too high arguing their value was roughly half of the department's assessed value. However, during the debate over the "Buy Back the Dams Initiative," a PPL representative, according to the Great Falls Tribune of September 29, 2002, argued the opposite: that the "state-assessed value of its plants is lower than their worth."

Puget Sound Energy is protesting a portion of its property taxes implying that the department should ignore its interest in the power line that takes the electricity they produce in Colstrip to the west coast. In effect, it appears they want their power plant interest to be valued as if it could not deliver its product to a market. The department considers this argument to be contrary to the concept of centrally assessed property established in Montana law. Again, this appeal was filed by a national accounting firm that receives its compensation as a portion of any tax reduction realized from the appeal.

Qwest is appealing a portion of its property tax value in Montana and a host of other states. Qwest has appealed its property taxes in several states in recent years. Thus, its appeals appear to be a regular business practice and not rationally related to the valuation practices of any individual state.

#### Statutory Expenditure Reduction Plan

As required by statute, the department developed a plan for reducing expenditures in fiscal year 2007. Actually, the department has developed two plans—one with across the board reductions and a second one with only discretionary reductions. Both plans are unacceptable and cost much more in lost state and local revenues than the amount of expenditures they would reduce. One of the plans would also delay refunds and otherwise disrupt services to citizens as well as violate statutory mandates, including the requirement to complete reappraisal by the end of 2008.

Before describing the two expenditure reduction plans, it should be noted that the need to pay for defending tax values and assessments occurs at the same time that the department is experiencing an estimated \$270,000 biennial shortfall in its funding for basic tax return and payment processing functions. More than half of that shortfall is due to a failure of the state's budgeting process to capture the department's actual, historic processing costs. Another portion is due to changes in procedures that will increase the accuracy of the department's electronic taxpayer records and the quality and quantity of information for revenue estimating to support gubernatorial and legislative decision-making. No supplemental funds are being sought for this \$270,000 shortfall, but its existence makes any other expenditure reduction plan more difficult to implement.

Under the first plan reducing \$1 million in expenditures in FY 07 spread across all general fund activities, the department would be forced to eliminate 24 positions and disrupt critical functions. This plan would:

- Reduce state and local revenue directly by an estimated \$11.8 million—nearly twelve times the expenditure reduction. \$4.1 million would be lost state general fund revenue, and \$7.7 million would be lost local revenue.
- Result in increased losses of state revenue due to greater tax non-compliance based on a perception that the department will not have sufficient resources to correct underreporting.

- Preclude the department from finishing the reappraisal of property mandated by law to be completed by December 31, 2008. The Property Assessment Division is already understaffed for the reappraisal process. The number of parcels per staff member has increased by more than 50% over the past decade. This expenditure reduction plan will put the reappraisal deadline beyond reach.
- Delay refunds to taxpayers beyond the 45-day statutory target and reduce the quality and availability of taxpayer assistance.

As negative as these consequences are, the only other alternative is for the department to make discretionary reductions. To avoid violating statutory mandates, delaying taxpayer refunds and disrupting taxpayer assistance, the \$1 million in reductions would need to be concentrated in audit and compliance activities. This second plan would:

- Reduce state and local revenue directly by an estimated \$7.2 million—over seven times the expenditure reduction. \$6.7 million would be lost state general fund revenue, and \$.5 million would be lost local revenue. Note that the state loss would be 63% greater under this plan than under the first plan.
- Result in increased losses of state revenue due to greater tax non-compliance based on a perception that the department will not have sufficient resources to correct underreporting.

These reductions are not in the best interest of the state maintaining the equity and integrity of its tax system.